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SUBJECT: HIGHER AUSTRALIAN DOLLAR MAY LEAD TO STRUCTURAL CHANGE

11. (SBU) SUMMARY: Underpinned by strong demand for Australian resources, a resilient post-GFC domestic economy, rising interest rates, and comparatively slower recoveries among other advanced economies, the Australian dollar (A\$) has been one of the strongest currencies in 2009. The strong dollar, however, is exerting pressure on export-oriented sectors. The higher A\$ is likely to shift resources from manufacturing to higher growth industries, such as the resources and energy sector, causing uneven effects across Australia. END SUMMARY.

Aussie Dollar: Sharp Rise

12. (U) The Australian dollar (A\$) appreciated by about a third in 2009, from a low USD 63 cents in March 2009 to above USD 94 cents at the beginning of November. It appreciated similarly against other currencies. Some analysts consider parity with the U.S. dollar likely during the next three to six months.

Higher Interest Rates Support A\$

13. (SBU) Australia was the first advanced economy to raise interest rates after the GFC, which it did in October and November 2009. Australian dollar-denominated investments are likely to remain in high demand because they offer better returns than their counterpart USD, British pound or yen-denominated investments. Most economists assess that as long as economic recovery keeps lagging elsewhere, particularly in the U.S., interest rate differentials with Australia - which support a strong A\$ -- should persist.

Strong A\$ Should Accelerate Structural Change

14. (SBU) Deputy Treasury for Macroeconomic Policy David Gruen told Econoff that a higher A\$ will inevitably shift resources from sectors such as manufacturing, agriculture, tourism and education towards higher-growth export industries, such as resources and energy. Reserve Bank Governor Stevens and Trade Minister Crean also acknowledge the strong A\$ is adversely affecting non-resource exporters.

15. (SBU) Gruen anticipates sensitivity to a higher A\$ will vary across regions in Australia. For instance, resource industries, mainly located in the states of Western Australia and Queensland, have offset the impact of the stronger A\$ with higher export volumes, especially to China. New South Wales and Victoria, however, where manufacturing is more prevalent, face a contracting sector. Implications of the stronger A\$ on important Australian economic sectors (manufacturing, agriculture and resources) are described below:

Manufacturing

¶16. (SBU) Cheaper imported inputs and machinery help partly offset lower export earnings, but not enough. Employment in manufacturing fell 2.8% in the year to August 2009 and currently accounts for 9.5% of the total workforce, down from 9.7% in the same quarter 2008. Industry Minister Kim Carr said, "We can't sustain this approach. Countries that have lost all their manufacturing are now desperate to re-establish it." Australian Industry Group Senior Economist Martin Petch told Econoff some sectors have adjusted or moved production offshore. The two leading manufacturing unions have already called for greater government assistance.

Agriculture

¶17. (SBU) The Australian Bureau of Agricultural and Resource Economics (ABARE) forecasts a decline of 3.4% in export returns from farm commodities in 2010. As in manufacturing, the strong dollar enables cheaper imported inputs, which partly offset lower export earnings and help lower some agriculture and food costs domestically. ABARE Chief Commodities Analyst Dr. Jamie Penm told Econoff that imports of inputs account for only 20% of farm costs.

Resources

¶18. (SBU) According to Penm, 2009-10 export returns from commodities are expected to fall by 24% due to the appreciation of the A\$ and

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lower contract prices -- traded in U.S. dollars -- for bulk commodities (such as coal and iron ore, which today represent almost 40% of Australian exports). The sector has offset lower A\$ returns by selling higher volumes, especially to China. The higher A\$ also enables firms to more easily import capital equipment and expand capacity. Mine production in 2009-10 is forecast to increase by 4.6%.

¶19. (SBU) COMMENT: The high dollar is expected to support a restructuring of the Australian economy, resulting in a substantially smaller traditional manufacturing sector and an expanded resources and energy sector. This may put political pressure on Prime Minister Rudd, who pledged the day he became ALP leader: "I don't want to be Prime Minister of a country that doesn't make things anymore."

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